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Economics Group

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ECB Hikes Rates As Portugal Seeks Help

As widely expected, the ECB hiked its main policy rate by 25 bps. Although another rate hike does not appear imminent, we look for a modest pace of tightening in the quarters ahead.

ECB Kicks Off Its Tightening Cycle

As widely expected, the European Central Bank (ECB) raised its main policy rate today by 25 bps, its first rate hike since July 2008 (top chart). The move had been telegraphed at last month's policy meeting when the ECB said in the policy statement that "strong vigilance is warranted with a view to containing upside risks to price stability." In the past, the words "strong vigilance" were used to signal that a rate hike was imminent.

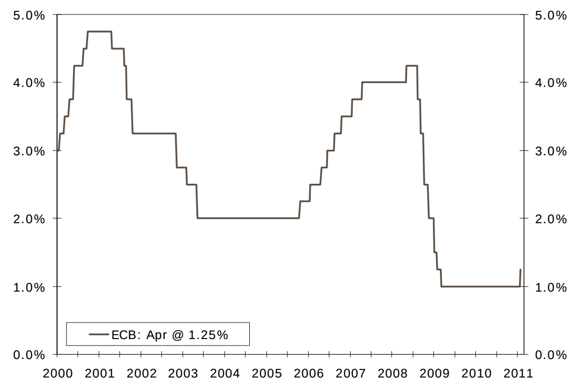
In the policy statement that was released this morning, the ECB gave no indication that another rate hike is just around the corner. That is, the ECB did not say that "strong vigilance" was required. However, it did indicate that it expects the economic expansion to continue in coming quarters, and the statement noted that "risks to the medium-term outlook for price developments remain on the upside." There is little evidence so far that recent increases in food and energy prices are spilling over into more broad-based inflationary pressures (middle chart). However, the ECB, which has a single mandate of "price stability," will remain alert to the potential pass-through to other prices.

In our view, the ECB will continue to hike rates over the course of the year, but we expect it to remain on hold for the next month or two. Growth in the euro area is positive at present, but it is not very strong. (Real GDP was up only 2.0 percent on a year-ago basis in the fourth quarter of 2010.) Moreover, we forecast that growth will remain sluggish for the foreseeable future as fiscal tightening in many countries continues to exert strong headwinds on economic growth. Our forecast calls for the ECB's main policy rate to reach 1.75 percent by the end of 2011.

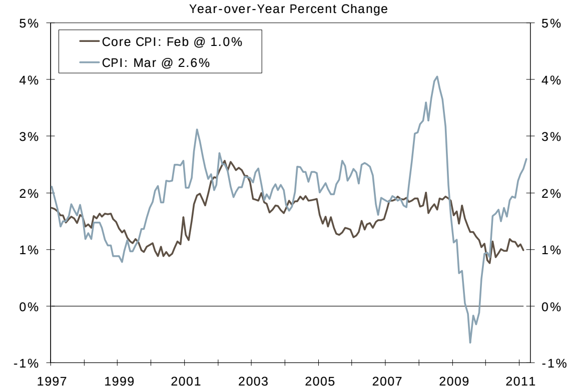
Portugal Seeks Bailout Package

The ECB's move today follows the announcement yesterday that Portugal would seek financial assistance from the European Commission. The rise in borrowing costs for the Portuguese government in recent weeks made the decision almost inevitable (bottom chart). The size of the request has not yet been announced, but we expect it to be more or less in line with the bailout package that Ireland received last year (€85 billion). Because most investors had already expected Portugal to seek a bailout package, the announcement had very little effect on financial markets. Importantly, government bond yields in Spain and Italy have not followed Portuguese rates higher in recent weeks. However, it would be premature to declare Spain and Italy as completely out of the woods. Slow economic growth in these two countries will make it difficult for their respective governments to quickly grow their way out of their financial difficulties. Therefore, Spanish and Italian bond yields likely will remain elevated as investors remain alert to the possibility of eventual debt restructuring in those countries.

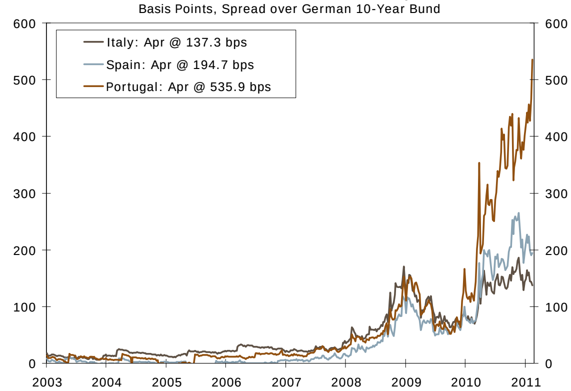
European Central Bank Policy Rate



Eurozone Consumer Price Inflation
Year-over-Year Percent Change



10-Year Government Bond Spreads
Basis Points, Spread over German 10-Year Bund



Source: Bloomberg LP, IHS Global Insight and Wells Fargo Securities, LLC

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